Office of the Minister of Finance

Chair
CABINET

2008 BUDGET STRATEGY

Proposal

1. This paper seeks Cabinet's agreement to a strategy and process for Budget 2008, including total funding allowances for operating and capital, and also notes an additional 'revenue reduction contingency' that Treasury has included in its forecasts. The paper also seeks Cabinet's agreement to delegate power to decide on theme allocations to the Prime Minister and the Minister of Finance.

2. The proposed strategy, which will be reflected in the 2008 Budget Policy Statement, takes into account latest macroeconomic and fiscal information and shows substantially stronger fiscal position than expected at Budget 2007. However, expanding our Budget allowances will require careful consideration of tradeoffs given economic uncertainties and the potential for further monetary policy tightening given current macroeconomic circumstances.

Executive Summary

3. We are currently enjoying a sustained period of economic expansion – the longest since the 1970s. This has seen the economy operating at or above its potential for some time now. Firms are reporting they have little spare capacity, labour force participation is very high and we have the lowest unemployment rate in decades. The economy's strong growth performance has created challenges. With limited spare capacity across the economy, firms are competing with each other for resources, including labour, to meet demand. While tight monetary policy and the global glut of savings saw the New Zealand dollar appreciate to a post-float high earlier in the year. As a result we see that:

    - Strong employment growth together with the fact most New Zealanders have skills in demand elsewhere in the world has led to skills shortages and wage pressures;
    - Sustained growth relative to capacity has contributed to stronger than expected inflation pressures;
    - The current account deficit remains high as some domestic demand has been met from imports and the high dollar is adversely affecting exporters; and
    - Some sectors of the economy are doing better than others, partly as a result of the high dollar, partly as a result of commodity price trends.

4. At the same time some long-term fiscal challenges remain, including the long-term projected rise in health expenditure.

5. Budget 2008 will build on our achievements made since 1999 and continue the Government's focus on long-term policy goals. The changes to personal income tax will continue an ongoing programme of tax reform. The Labour-led Government's personal tax package will be consistent with our overarching goals by focussing primarily on fairness, without sacrificing quality public services. The package will be consistent with our medium-term approach to fiscal policy by maintaining gross debt as a proportion of GDP at around 20%. And we will be cognisant of short-term imbalances in the economy by not imparting a greater fiscal impulse than previously forecast.

6. Treasury's higher revenue forecasts provide us with options for increasing allowances while still maintaining consistency with our fiscal strategy. The higher terms of trade (at a 30 year high), and in particular higher world dairy prices (which have doubled in the past year) have been key drivers of the higher than expected nominal economy. The uncertainty surrounds the ongoing path of dairy prices, in terms of both the final magnitude and duration of the increase in the terms of trade.

7. The economic and fiscal uncertainties complicate fiscal decision-making. The Government needs to take fiscal decisions that are robust to plausible fluctuations. This is an especially important consideration if the final outturns prove to be below our current forecasts. Were we to move ahead with our full agenda on the basis of present forecasts, and then find ourselves stretched beyond available fiscal headroom, we would face a difficult process of winding back developed policy.

8. The Treasury's forecasts build in a revenue reduction contingency of $1.5 billion. It is assumed that the contingency is used for personal tax initiatives from April 2009. This is a modelling assumption only as the exact shape and timing of any revenue reductions have yet to be determined.

9. We are currently faced with a number of pressing infrastructure pressures that will make a substantial contribution to New Zealand's social and economic development. For this reason I recommend increasing the capital allowance to $1.8 billion, spread across the forecast period.

10. Updated forecasts show us running cash deficits across the medium term consistent with our debt and operating balance objectives. This means that we anticipate effectively meeting some of our capital spending commitments from borrowing. So, while we are still working through our personal tax cut package, its final size and shape will be consistent with our fiscal strategy.

11. Any decision taken at Budget 2008 on further increases to allowances will be based upon the medium-term benefits of prospective initiatives. Notwithstanding this focus, the Government will remain conscious of current pressures on inflation.

Comment

Updated macroeconomic forecasts indicate a slightly larger than expected real economy…

12. Real GDP growth is forecast to increase from the 1.7% recorded in March 2007 to 3.0% in the year to March 2008. In part the pick-up in growth reflects the strong growth we witnessed during the first half of the year but also the boost the economy is getting from the high terms of trade. Growth is expected to ease back, however, in 2008/09 to about 2% before increasing to around 3% in 2009/10 and beyond.

13. The Treasury expects private consumption growth to be more modest over coming quarters than it was during late 2006 and early 2007 as households react to higher mortgage rates and relatively high petrol costs. Growth in residential investment is expected to be negative over most of the forecast period, consistent with signs of a weakening in the housing market. Export volume growth, while positive, is expected to remain low this year and next as a result of the high exchange rate. However, higher farm incomes, a robust labour market generating low unemployment and solid income growth and the impact of higher terms of trade provide a solid underpinning to growth. Government spending will also contribute on an ongoing basis to total growth. Combined these factors limit the extent of slowing in real GDP growth.

***…and a significantly bigger nominal economy*.**

14. The consequence of stronger real GDP growth is that spare capacity in many sectors remains very limited. This means price pressures remain high in many parts of the economy. The global rise in food prices (of which dairy is an obvious indicator) and oil is adding to price pressures. Annual CPI inflation is expected to increase to around 3% in the current December quarter. Slightly higher real GDP growth, together with higher terms of trade and inflation, result in nominal GDP growth in 2007/08 and 2008/09 significantly higher than Treasury previously expected.

The impact of recent financial market developments on global growth is a risk to the outlook…

15. Treasury's forecasts assume that recent international developments on world financial markets and the US housing market do not cause a marked slowing in global growth. A more severe slowing in world growth or greater impact from tighter monetary policy conditions than anticipated would make conditions more difficult for New Zealand businesses and households, through its impact on access to, and the cost of, credit and via demand for New Zealand exports.

…but the path of the terms of trade (especially dairy prices) is the major uncertainty for these forecasts.

16. Higher terms of trade, in particular world dairy prices, play a key role in the higher nominal GDP forecast. The Treasury's forecasts assume that dairy prices will ease back from current very high levels over the forecast period but nevertheless remain strong by historical standards. However, accurately predicting future dairy prices is inherently difficult due to volatility in both world demand and

supply. This implies uncertainty about the magnitude and the duration of the current rise in the terms of trade as well as its impact on the economy. The uncertainty rises as the horizon is extended given the ability of suppliers to respond to higher demand and prices.

Higher nominal GDP forecasts lead to higher tax revenue forecasts…

17. Higher nominal GDP leads to higher tax revenue forecasts than were expected at Budget 2007. The high level of uncertainty about the terms of trade and hence nominal GDP growth implies an extra element of uncertainty around revenue forecasts.

18. Abstracting from these uncertainties, Treasury's updated fiscal forecasts and projections show the government's fiscal position stronger than expected at Budget 2007. This opens up additional fiscal policy choices with respect to operating spending, taxation, and capital expenditure.

…but using the fiscal policy flexibility may involve some difficult and complex judgements.

19. Treasury forecasts CPI inflation to be above 2.5% for 2008/09 through to 2010/11. The Reserve Bank sees inflation even higher over the next few years and some private sector forecasters higher still. The Reserve Bank's interpretation is likely to be that any further material addition to aggregate demand over the short- to medium-term, regardless of the source, will add to inflation pressures.

20. One set of judgements for increasing allowances relates to medium-term growth benefits that are expected from new initiatives. Initiatives that impact over the medium term on labour participation, investment, and productivity will help to eventually reduce inflationary pressures, and boost long-term per capita incomes.

In setting allocations we need to send the signal that we expect departments to manage capability and wage-related bids from within baselines.

21. Senior Ministers have previously expressed concern about the growth in the size and wage cost of the core public sector, and on the ability to employ extra staff or undertake further capital work in the current economic environment. In Budget 2007, wage related bids totalled $268 million for the 2007/08 year, of which we funded $227 million.

22. Some progress has already been made, for example the Ministerial Reference Group on public sector wages agreed to provide advice to Ministers and departments which:

    a. Reinforces the expectation that wage and capability costs are expected to be met from within baselines; and

    b. Establishes some set criteria to define the exceptions under which Ministers will consider new funding for wages and capability.

23. In addition, I have directed Treasury to provide advice to theme co-ordinating Ministers, to me and to Senior Ministers on the implications on staffing numbers of individual and total capability bids, as part of the consideration of capability initiatives.

I recommend taking a cautious approach and signalling an increase in operating and capital allowances but not using up all of the available fiscal headroom at this stage.

24. I recommend retaining operating allowances for Budgets 2008-2010 at levels previously agreed at Budget 2007. The Budget 2008 allowance includes meeting the costs of the Business Tax Reform from 2008/09 – the amount available for spending is similar to the last two Budgets (i.e. around $2 billion):

Operating allowances for Budgets 2008-2010

Operating allowances ($ millions)	**2008/09**	**2009/10**	**2010/11**	**2011/12 & outyears**
Budget 2008	3,033	3,112	3,107	3,107
Budget 2009	-	2,016	2,016	2,016
Budget 2010	-	-	2,057	2,057

25. In addition to the formal operating allowances, Treasury's forecasts will also incorporate a 'revenue reduction contingency' of $1.5 billion. The $1.5 billion amount is a modelling assumption only at this stage. If the additional fiscal headroom that this contingency represents is supported by further information, I recommend we use it and potentially additionally headroom available to deliver personal tax cuts in Budget 2008.

26. The capital allowance for Budget 2008 is currently $900 million. This is considerably smaller than Budget 2007, when we committed $1.6 billion of new capital funding across the forecast period.

27. Items where little discretion exists (e.g. cost guarantee for transport and Defence long-term development plan) would take up most of the $900 million allowance, and I am aware of the number of substantial capital priorities that are emerging that we might want to consider. The Budget 2007 between-budget contingency for capital is also overspent by $141 million, and this overspend needs to be met from Budget 2008.

28. Notwithstanding considerations discussed above, there is more certainty associated with the extra revenue at the beginning of the forecast period available for one-off spending. For these reasons I recommend increasing the Budget 2008 capital allowance from $900 million total to $1.8 billion total.

Proposed increase in capital allowances for Budget 2008

Capital allowance ($ millions)	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**Total**
Previously	20	480	250	150	-	**900**
Proposed	48	992	330	200	230	**1,800**

29. This is a considerable increase on the previously signalled capital allowance for Budget 2008. However, a portion of additional capital will be targeted at initiatives which will not fully impact on domestic demand over the short term (e.g. purchasing defence equipment overseas). This means the additional capital signalled in the headline allowance overstates the possible impact on demand and inflation. With the proposed revision to the allowance for Budget 2008, the capital allowances for Budgets 2008-2010 are as follows:

Capital allowances for Budgets 2008-2010

Capital allowances ($ millions)	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**Total**
Budget 2008	48	992	330	200	230	-	**1,800**
Budget 2009	-	20	480	250	150	-	**900**
Budget 2010	-	-	20	480	250	150	**900**

30. Even with this proposed increase to the capital allowance considerable strain on capital in Budget 2008 will remain. Additionally, a number of sectors within the economy (and in particular the construction sector), which have traditionally been the final recipients of a significant amount of the Government's capital expenditure, are facing capacity constraints. I have asked Treasury to provide me with options for easing the pressures in the economy by either scaling or deferring selected upcoming capital projects being funded from departments' balance sheets.

31. To help manage this strain, I propose that I hold bilaterals with individual Vote Ministers to discuss all capital initiatives. This approach would allow me to retain overall oversight of the Government's infrastructure investment mindful of total available fiscal and economic resources.

While the Budget 2008 operating allowance is under some strain it is in a better position than the Budget 2007 allowance was at this stage last year.

32. As the table below demonstrates, pre-commitments against the 2008 Budget operating allowance account for $2.1 billion (68%) of the $3.1 billion available in 2011/12. This means that we have around $1 billion per annum to allocate to other items in the 2008 Budget:

Pre-commitments against the 2008 Budget operating allowance

$ millions, GST exclusive	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**
Budget 2008 operating allowance	**-**	**3,033**	**3,112**	**3,107**	**3,107**
Pre-commitments:					
Economic Transformation					
Business Tax Reform	-	1,056	1,135	1,130	1,130
Families - Young and Old					
Health	-	750	750	750	750
National Identity					
Defence Funding Package	-	69	69	69	69
Other					
Overspend of Budget 2007 Between-Budget Contingency as at 26-Nov-07	43	(12)	(14)	(16)	(16)
Ministry of Foreign Affairs and Trade	-	25	63	107	146
Funding remaining for other priorities	**(43)**	**1,144**	**1,108**	**1,067**	**1,028**

33. In addition to the above formal pre-commitments, I am aware of the number of operating initiatives that may be presented for consideration during Budget 2008 where the Government may have limited discretion over whether the items are funded. Additionally, both the Economic Transformation and Families – Young and Old themes have developed a set of priorities for the short to medium term. To the extent that these priorities require additional fiscal resources for advancement, further initiatives associated with these priorities will be submitted for consideration as theme packages are developed in Budget 2008.

34. Our priorities are important for maintaining the strategic direction of our longer term policy programme. I recommend confirming the priorities for Economic Transformation and Families – Young and Old as a basis for informing the development of theme packages in Budget 2008 as set out in Annex 1 and Annex 2 respectively.

35. While all theme priorities are important for advancing the each theme's policy agenda, I would note the need to maintain a realistic perspective on what can be achieved in Budget 2008. In preparing a theme package, theme groups may choose to focus on a sub-set of these theme objectives, rather than feeling that they must allocate some funding to all of the objectives.

36. One aspect of beginning the theme process for Budget 2008 is to set individual theme allocations within the overall Budget 2008 operating allowance. Setting these allocations will require balancing a difficult set of tradeoffs regarding the priorities for what we want to achieve in the themes and our personal tax package. These judgements must also be conscious of the complex and evolving macroeconomic and fiscal context within which we are operating. To facilitate timely decision-making on these allocations, I recommend delegating the power to determine on theme allocations to the Prime Minister and the Minister of Finance.

Next steps for Budget 2008

37. The following table sets out the broad timetable for the remainder of Budget 2008:

Broad timetable for the remainder of Budget 2008

Event	**Date**
Budget initiatives due	14 December 2007
Capital and 'Other' bilaterals	February 2008
March Baseline Update submissions due	Early March 2008
Decision-making within themes	December 2007-March 2008
Senior Ministers' meeting on themes	Mid-late March 2008
Cabinet decisions on the Budget package	Mid-April 2008
Budget Day	May 2008

38. Theme Ministers will soon receive letters from me setting out details around the initiatives phase and the operation of allocations.

Financial Implications

39. This paper seeks Cabinet's agreement to a strategy for Budget 2008, including overall funding allowances for operating and capital and noting a revenue reduction contingency. Final funding decisions, including changes to appropriations, will be sought from Cabinet in April 2008.

Other Implications

40. There are no legislative, Treaty or Human Rights Act implications. A Regulatory Impact Statement is not required.

Publicity

41. The high-level decisions in this paper will be announced in the 2008 Budget Policy Statement, to be tabled on 18 December 2007, with the Half Year Economic and Fiscal update.

Consultation

42. Senior Ministers have been consulted on the strategy outlined in this paper.

Recommendations

I recommend that Cabinet:

Overall funding allowances for Budget 2008

1. **note** that updated fiscal forecasts show the government fiscal position stronger than in Budget 2007 documents;

2. **note** that there are significant uncertainties associated with Treasury's forecasts, particularly around the magnitude and sustainability of the current rise in the terms of trade, which implies an extra element of uncertainty around revenue forecasts, particularly in the medium-term;

3. **note** that we should take uncertainties around the economic and fiscal forecasts into account when setting budget allowances;

4. **note** that inflation pressures in the economy remain high and the Reserve Bank's interpretation is likely to be that any further material addition to aggregate demand, regardless of the source, will add to these pressures;

5. **note** that initiatives that positively impact on labour participation, investment and productivity would help to reduce inflationary pressures over the medium-term;

6. **confirm** the following operating allowances for Budgets 2008-2010:

Operating allowances for Budgets 2008-2010

Operating allowances ($ millions)	2008/09	2009/10	2010/11	2011/12 & outyears
Budget 2008	3,033	3,112	3,107	3,107
Budget 2009	-	2,016	2,016	2,016
Budget 2010	-	-	2,057	2,057

7. **note** that Treasury's Half Year Economic and Fiscal forecasts from 2008/09 will incorporate a 'revenue reduction contingency' of $1.5 billion. This working assumption is that this allowance will be used for personal tax cuts starting on 1 April 2009. Together, the existing operating allowance and revenue reduction contingency have a total operating balance impact of $4.6 billion per annum in outyears;

8. **agree** to increase the Budget 2008 capital allowance by $900 million over the forecast period to enable us to better meet a number of capital priorities we will need to fund;

9. **confirm** the following capital allowances for Budgets 2008-2010:

Capital allowances for Budgets 2008-2010

Capital allowances ($ millions)	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	Total
Budget 2008	48	992	330	200	230	-	**1,800**
Budget 2009	-	20	480	250	150	-	**900**
Budget 2010	-	-	20	480	250	150	**900**

10. **agree** that the Minister of Finance will hold bilaterals with Vote Ministers on all capital initiatives;

Helping themes to manage wage and capital pressures

11. **note** that the Ministerial Reference Group on public sector wages agreed to provide advice Ministers and departments to reinforces expectations around general capability initiatives being met from baselines and establish criteria to define the exceptions;

12. **note** that Treasury will provide advice to theme co-ordinating Ministers, to me and to Senior Ministers on the implications on staffing numbers of individual and total capability bids, as part of the consideration of capability initiatives;

13. **note** that Treasury will provide me with options for easing pressures on the capital allowance and on the construction sector by either scaling or deferring selected upcoming capital projects being funded from departments' balance sheets;

Theme priorities and allocations for Budget 2008

14. **note** that pre-commitments against the Budget 2008 operating allowance account for around $2.1 billion, or 68%, of the available funding:

Pre-commitments against the Budget 2008 operating allowance

$ millions, GST exclusive	2007/08	2008/09	2009/10	2010/11	2011/12
Budget 2008 operating allowance	**-**	**3,033**	**3,112**	**3,107**	**3,107**
Pre-commitments:					
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Ministry of Foreign Affairs and Trade	-	25	63	107	146
Funding remaining for other priorities	**(43)**	**1,144**	**1,108**	**1,067**	**1,028**

15. **confirm** the priorities for Economic Transformation as outlined in Annex 1;

16. **agree** to the priorities for Families – Young and Old as outlined in Annex 2;

17. **note** that in preparing a theme package, theme groups may choose to focus on a sub-set of these theme objectives, rather than feeling that they must allocate some funding to all of the objectives;

18. **delegate** power to determine theme allocations to the Prime Minister and the Minister of Finance;

Next steps for Budget 2008

19. **note** the following broad timetable for the remainder of Budget 2008:

Event	**Date**
Budget initiatives due	14 December 2007
Capital bilaterals	February 2008
Bilaterals for the ‘Other’ theme	March 2008
March Baseline Update submissions due	Early March 2008
Decision-making within themes	December 2007-March 2008
Senior Ministers’ meeting on themes	Mid-late March 2008
Cabinet decisions on the Budget package	Mid-April 2008
Budget Day	May 2008

20. **note** that I will write to theme coordinating Ministers prior to 14 December setting out details around the initiatives phase and the operation of allocations;

Hon Dr Michael Cullen
Minister of Finance

ANNEX 1

ECONOMIC TRANSFORMATION OBJECTIVES

Five sub-themes: World Class Infrastructure (WCI); Environmental Sustainability (ES); Innovative and Productive Workplaces (IPW); Growing Globally Competitive Firms (GGCF); and Auckland (AKL).

Six priorities under these sub-themes:

1. Improving access to quality, fast, reliable broadband services to ensure strong global connections (WCI);
2. Positioning New Zealand as a world-leading exponent of smart and innovative responses to environmental issues (ES);
3. Developing workplace skills, focusing on literacy and numeracy (IPW);
4. Supporting business internationalisation and extracting the best value from global value chains (GGCF);
5. Focusing government investment in areas that reflect and extend New Zealand's strengths (GGCF);
6. Making Auckland a world-class hub of innovation and internationalisation (AKL).

Ten actions for the medium term under these priorities:

- Accelerating investment in broadband (1);
- Implement emissions trading and associated carbon markets to reduce net greenhouse gas emissions (2);
- Advance environmental solutions, including sustainable land management, eco-verification and test beds for sustainability (2);
- Developing instruments to provide for water quality and future demand for fresh water (2);
- Upskilling the workforce (3);
- More sophisticated and integrated in-market business support (4);
- Integrated and targeted onshore support for internationalising firms, and business opportunities with international potential, with a focus on capability development (4);
- Tackling fragmentation and better aligning government spend across education and training, RS&T, business and market developing in six areas of focus, namely: Pastoral systems; environmental solutions; health solutions; advanced foods; advanced materials; and digital content (5);
- Supporting the development of the Auckland Innovation Precinct (6); and
- Enhancing Auckland's Waterfront and Supply Chain Effectiveness (6).

ANNEX 2

FAMILIES – YOUNG AND OLD OBJECTIVES

In May 2007, FYO Ministers agreed the following priorities for Budget 2008:

- Effective Interventions;
- Early Years; and
- Eliminating Family Violence.

In October 2007, senior FYO Ministers agreed that the following additional priorities would be advanced in Budget 2008:

- Realising Youth Potential; and
- Developing the NGO Sector.

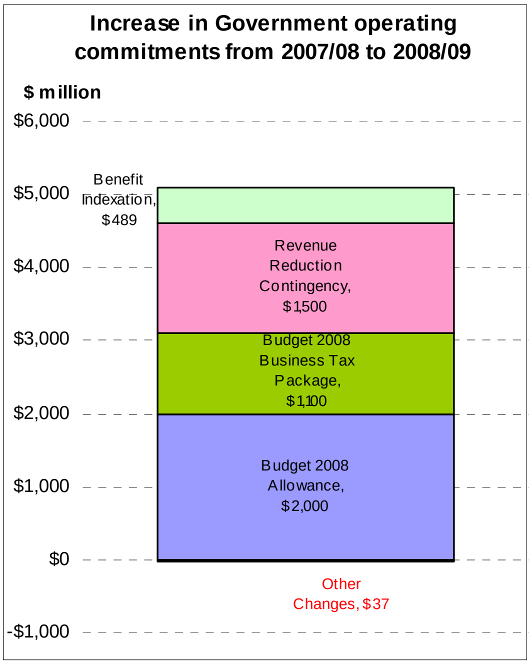
Additionally, it is expected that FYO theme will need to cover a number of initiatives associated with:

- Confidence and Supply agreements;
- Wage Pressures; and
- Key Business and Service Delivery Failures.

ANNEX 3

Increase in Government commitments between 2007/08 and 2008/09

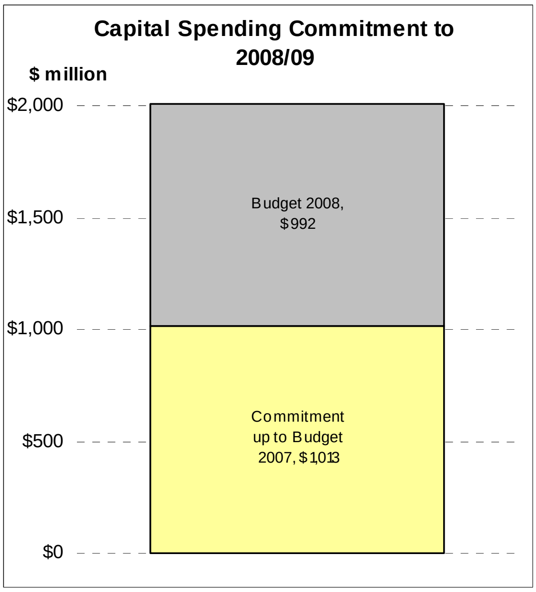
Operating commitments



In the next financial year Government decisions will lead to an increase of $5,052 million in total operating expenses. The increase is driven by:

- Budget 2008 operating allowance of $2,000 million.
- The parts of the Business Tax Package impacting in Budget 2008 ($1,100 million)
- The revenue reduction contingency of $1,500 million
- Changes to some well-established policies that are often indexed to inflation or are demand-driven. Benefit indexation will increase 2008/09 by a total of $489 million.

Capital spending committed to 2008/09



Total spending on capital committed by this Government for the next financial year in Budget 2008 and in previous Budgets is approximately $2,000 million.

- Budget 2008 has an allocation of $992 million in capital projects in 2008/09.
- In previous Budgets this Government committed an additional $1,013 million to the 2008/09 financial year. Note that while this is the amount that was budgeted for in previous years, the actual spending could vary depending on the timing changes made.